

arguments concerning Amendment No. 1. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-95-39 and should be submitted by November 16, 1995.

V. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act, and, in particular, Section 6 of the Act.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,³³ that the proposed rule change (File No. SR-CBOE-95-39), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁴

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-36401; File No. SR-CHX-95-10]

Self-Regulatory Organizations; Chicago Stock Exchange, Incorporated; Order Granting Approval to Proposed Rule Change Relating to Permanent Approval of the Pilot Program for Stopped Orders in Minimum Variation Markets

October 20, 1995.

I. Introduction

On March 23, 1995, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act

of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to approve permanently its stopping stock program in minimum variation markets.

The proposed rule change was published for comment in Securities Exchange Act Release No. 35910 (June 28, 1995), 60 FR 34563 (July 3, 1995). No comments were received on the proposal.³ For the reasons discussed below, the Commission has decided to approve the CHX's proposal.

II. Description of Proposal

Prior to 1992, CHX Rule 37, Article XX, required specialists, upon request, to grant a stop for Dual Trading System issues⁴ if an out of range⁵ execution would result, regardless of the spread. Under this stopping stock policy, the specialists were required to execute stopped stock based on the next primary market sale. The Exchange's purpose for stopping stock generally was to prevent orders from being executed outside the primary market range for the day (*i.e.*, from establishing a new high or new low).⁶

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Commission has received three comment letters opposing the New York Stock Exchange's proposal for permanent approval of the NYSE's procedures for stopping stock in minimum variation markets, two of which were from the same commenter (Junius Peake). See letter from Junius W. Peake, Monfort Professor of Finance, University of Northern Colorado, to Secretary, SEC, dated March 1, 1995; letter from Junius W. Peake, Monfort Professor of Finance, University of Northern Colorado, to Secretary, SEC, dated July 21, 1995; letter from Morris Mendelson, Professor Emeritus of Finance, the Wharton School of the University of Pennsylvania to Jonathan Katz, Secretary, SEC, dated August 2, 1995. Although the NYSE's procedures differ from those of CHX, certain issues raised in the comment letters apply equally to the CHX proposal. The comment letters and the NYSE's response thereto are summarized in the Commission's order. In addition, the Commission's discussion in the NYSE order is applicable to this order. See Securities Exchange Act Release No. 36399 (Oct. 20, 1995) (permanently approving NYSE's pilot program for stopping stock in minimum variation markets); see also letter from James Buck, Senior Vice President and Secretary, NYSE, to Jonathan Katz, Secretary, SEC, dated July 17, 1995.

⁴ The Dual Trading System of the Exchange allows the execution of both round-lot and odd-lot orders in certain issues assigned to specialists on the Exchange and listed on either the New York Stock Exchange or the American Stock Exchange.

⁵ "Out of range" means either higher or lower than the range in which the security traded on the primary market during a particular trading day.

⁶ For example, assume the market in ABC stock is 20-20½; 50x50 and that a buy order at 1/8 would be higher than the range in which the security traded on the primary market during the trading day. A customer places an order with the Exchange specialist to buy 100 shares of ABC at the market and a stop is effected. The order is stopped at 20½ and the Exchange specialist includes the order in his quote by bidding the 100 shares at 20. If the next sale on the primary market is for 100 shares at 20, the Exchange's existing general policy regarding

This general stopping stock policy, however, produced an anomalous result in minimum variation markets.⁷ In a minimum variation market because the stopped market order did not have time or price priority, its execution triggered the requirement for the Exchange specialist to execute all pre-existing orders based on the Exchange's rules of priority and precedence.⁸ Therefore, the specialists were required to execute the preexisting orders even if such orders were not otherwise entitled to be filled.⁹

In January 1992, the Commission approved on a pilot basis the Exchange's revised procedures for stopping orders in minimum variation markets that would prevent the anomalous consequence of requiring the execution of pre-existing orders that are not yet due a fill.¹⁰ The Commission subsequently extended the Exchange's pilot program without modification.¹¹ The most recent extension of the pilot program is scheduled to expire on October 21, 1995.

The pilot program adds interpretation and policy .03 to Rule 37, Article XX, to permit a specialist to delay execution of stopped stock in minimum variation markets until a volume equal to the pre-

stopping stock would require the specialist to execute the stopped market order at 10.

⁷ CHX Rule 22, Article XX sets forth the minimum variations for stocks traded on the Exchange. The rule provides that bids or offers in stocks above \$1.00 per share shall not be made at a less variation than 1/8 of \$1.00 per share; in stocks below \$1.00 but above \$.50 per share, at a less fraction than 1/16 of \$1.00 per share; in stocks below \$.50 per share, at a less variation than 1/32 of \$1.00 per share; provided that the Committee on Floor Procedure may fix variations of less than the above for bids and offers in specific securities or classes of securities.

⁸ See CHX Rule 16, Article XX (Precedence of Bids at Same Price).

⁹ Under CHX Rule 37(a)(3), Article XX, the Exchange specialists are required to fill orders at the limit price only if: (1) The bid or offering at the limit price has been exhausted in the primary market; (2) there has been a price penetration of the limit in the primary market; or (3) the issue is trading at the limit price on the primary market unless it can be demonstrated that such order would not have been executed if it had been transmitted to the primary market or the broker and specialist agree to a specific volume related or other criteria for requiring a fill.

¹⁰ See Securities Exchange Act Release No. 30189 (Jan. 14, 1992), 57 FR 2621 (Jan. 22, 1992) (File No. SR-MSE-91-10) (order approving MSE pilot program for stopped orders in minimum variation markets) ("1992 Approval Order").

¹¹ See Securities Exchange Act Release Nos. 31975, (Mar. 10, 1993), 58 FR 14230 (Mar. 16, 1993) (File No. SR-MSE-93-04) ("March 1993 Approval Order"); 32457 (June 11, 1993), 58 FR 33681 (June 18, 1993) (File No. SR-MSE-93-14) ("June 1993 Approval Order"); 33790 (Mar. 21, 1994), 59 FR 14434 (Mar. 28, 1994) (File No. SR-MSE-93-30) ("1994 Approval Order"); 35431 (Mar. 1, 1995), 60 FR 12796 (Mar. 8, 1995) (File No. SR-CHX-95-04) ("March 1995 Approval Order"); 36011 (July 21, 1995), 60 FR 38874 (July 28, 1995) ("July 1995 Approval Order").

³³ 15 U.S.C. 78s(b)(2) (1988).

³⁴ 17 CFR 200.30-3(a)(12) (1994).

existing volume ahead of the stopped order prints in the primary market.¹² Specifically, the specialist would be required to execute stopped market orders in minimum variation markets after (1) a transaction takes place on the primary market at the bid price (offering price) or lower (higher) for a stopped sell order (a stopped buy order) or (2) the displayed CHX share volume at the offering (or bid) has been exhausted. In no event would a stopped order be executed at a price inferior to the stopped price.¹³ All stopped orders must be executed by the end of the trading day.

In the orders approving the pilot procedures, the Commission requested that the Exchange study the effects of stopping stock in minimum variation markets and collect certain data to allow the Commission to evaluate fairly and comprehensively the pilot program.¹⁴ In the Commission's 1994 Approval Order extending the pilot program until March 21, 1995, the Commission requested that the Exchange submit an additional monitoring report on the stopping stock pilot.¹⁵ CHX subsequently submitted the monitoring report and the Commission then approved an extension of the pilot until October 21, 1995, so that the Commission would have additional time to evaluate the information provided by the Exchange and the CHX's use of its pilot procedures.

III. Discussion

After careful consideration, the Commission has determined to approve permanently the proposed rule change. For the reasons discussed below, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5)¹⁶ and Section 11(b)¹⁷ of the Act.

Historically, the Commission has had mixed reactions about the practice of stopping stock. The 1963 Report of the

Special Study of the Securities Markets found that unexecuted customer limit orders on the specialist's book might be bypassed by the stopped orders.¹⁸ The Commission, nevertheless, has allowed the practice of stopping stock in markets where the spread is at least twice the minimum variation because the possible harm to orders on the book is offset by the reduced spread that results and the possibility of price improvement.

Although the procedures for stopping stock in minimum variation markets do not reduce the spread between the quotes, the Commission has allowed, on a pilot basis, the practice on the Exchange in limited circumstances. The Exchange's procedures for stopping stock in minimum variation markets were intended to assist specialists in providing an opportunity for primary market price protection to the customer whose order is stopped, without requiring that specialists execute all pre-existing bids or offers when such executions otherwise would not be required under Exchange rules. The CHX pilot procedures allow specialists to delay execution of the stopped stock until a volume equal to the pre-existing volume ahead of the stopped order prints in the primary market. Specifically, the specialist would be required to execute stopped market orders in minimum variation markets either (1) at the stopped price after a transaction takes place on the primary market at the bid price or lower (or the offering price of higher) on the primary market or (2) at an improved price after the displayed CHX share volume has been exhausted.

To examine whether specialists have been using the pilot program as intended, the Commission had asked the Exchange to provide data on the stopping stock program in minimum variation markets. The Exchange has submitted to the Commission several monitoring reports regarding the stopping stock pilot program. The Commission believes that the monitoring reports, especially, the latest monitoring report, provide useful information regarding the effectiveness of the program during the pilot period.

Specifically, the Exchange reports that only approximately 2%-6% of the stopped orders received an out-of-range

execution despite having been stopped and, thus, did not benefit from the CHX proposal.¹⁹ With respect to the limit orders on the opposite side of the market from all market orders stopped in minimum variation markets, the Exchange reports that approximately 52% were executed before the close.²⁰ Moreover, almost all of the stopped orders were orders for 2000 shares or less.²¹ Finally, CHX reports that there has been no compliance problems with respect to the pilot program.

The Commission believes that the data on the stopping stock in minimum variation markets show that the pilot program has continued to help reduce the potential that an order may receive an out-of-range execution. Moreover, the procedures enable specialists to offer the opportunity for price improvement to small size orders. The Commission believes that the reduction in out-of-range executions, coupled with price improvement opportunities, sufficiently offset the possible harm to the opposite side limit orders on the book. The Commission recognizes the unintended consequence that can arise from the interplay between a regional exchange's price protection rules and its procedures for stopping stock. In the Commission's opinion, the CHX data suggests that stopped stock generally has been executed in accordance with traditional auction market principles.²² The Commission, therefore, believes that the data on stopping stock in minimum

¹⁹ The Commission notes that this pilot program is intended to prevent orders from being executed outside the primary market range for the day (*i.e.*, from establishing a new high or new low). Consistent with that policy, the CHX requires the specialist to execute stopped stock based on the next primary market sale. Specifically, if the next sale is at a better price, the stopped stock may, depending on the depth of the specialist's limit order book at that price, receive price improvement. However, if the next primary market sale is at the stop price (or worse), the order would receive the stop price.

Conversely, an order may not benefit from the CHX proposal if, despite having been stopped, it ultimately receives an out-of-range execution. In a minimum variation market, this can occur if, by the close, (1) the primary market has not traded at the stop price and (2) *all* pre-existing limit orders on the CHX specialist's book at the better price have not been executed.

²⁰ The Exchange reports that approximately 48% of the limit orders on the opposite side of the market from all market orders stopped in minimum variation markets were not executed by the end of the day. This percentage, however, overstates the number of limit orders that were not executed as a result of the stopped orders because it includes all limit orders on the opposite side of the market at the time of the stop rather than being limited to the size of the stopped order. Therefore, some of these limit orders that were not executed by the end of the trading day would not have been executed regardless of the stopped orders.

²¹ This data indicates the pilot program is benefiting small public customer orders.

²² See *infra* note 27.

¹² A stopped buy (sell) order would be placed behind the existing limit orders at the bid (offer) for priority purposes.

¹³ Exchange Rule 28 (Article XX) states:

An agreement by a member or member organization to "stop" securities at a specified price shall constitute a guarantee of the purchase or sale by him or it of the securities at the price or its equivalent in the amount specified.

If an order is executed at a less favorable price than that agreed upon, the member or member organization which agreed to stop the securities shall be liable for an adjustment of the difference between the two prices.

¹⁴ See *supra* notes 10-11.

¹⁵ See 1994 approval Order, *supra* note 11.

¹⁶ 15 U.S.C. 78f.

¹⁷ 15 U.S.C. 78k.

¹⁸ See SEC, Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Congress., 1st Sess., Pt. 2 (1963).

When stock is stopped, limit book orders on the opposite side of the market do not receive an immediate execution. Consequently, if the stopped order then receives an improved price, limit orders at the top price are bypassed and, if the market turns away from that limit, may never be executed.

variation markets show that the pilot has operated as intended and should be approved permanently.

For all of the above reasons, the Commission believes that the CHX proposal is consistent with Section 6(b)(5) of the Act. Moreover, the Commission also believes that the proposal is consistent with the Rule 11b-1(a)(2)(ii) of the Act.²³ Rule 11b-1(a)(2)(ii) requires that a specialist engage in a course of dealings for his own account that assist in the maintenance, so far as practicable, of a fair and orderly market. As previously noted in the 1992 Approval Order, the Commission believes that the proposal is consistent with the objectives of this Rule because the implementation of the proposal should help the specialist to provide an opportunity for price improvement to the customer whose stop order is granted, without placing a burden on specialists by requiring that specialists execute other pre-existing bids or offers when such executions would not be otherwise required under Exchange rules.

The Commission also believes that the proposal is consistent with the prohibition in Section 11(b) against providing discretion to a specialist in the handling of an order.²⁴ Section 11(b) was designed, in part, to address potential conflicts of interest that may arise as a result of the specialist's dual role as agent and principal in executing stock transactions. In particular, Congress intended to prevent specialists from unduly influencing market trends through their knowledge of market interest from the specialist's book and their handling of discretionary agency orders.²⁵ The Commission has stated that, pursuant to Section 11(b), all orders other than market or limit orders are discretionary and therefore cannot be accepted by specialists.²⁶

As previously noted in the 1992 Approval Order, the Commission believes that it is appropriate to treat stopped orders, even those under the pilot procedures, as equivalent to limit orders. A limit order is an order to buy or sell a stated amount of security at a specified price, or better if obtainable. The Commission believes that stopped orders are equivalent to limit orders, in this instance, because the orders would be automatically elected after a transaction takes place on the primary market at the stopped price. The

Commission, therefore, believes that the requirements imposed on the specialist for granting stops in minimum variation markets provide sufficiently stringent guidelines to ensure that the specialist will implement the proposed rule change in a manner consistent with his market making duties and Section 11(b).²⁷

In permanently approving the Exchange's proposal, the Commission expects the Exchange to continue monitoring the practice of stopping stock in minimum variation markets and to take appropriate action in the event CHX identifies any instances of specialist non-compliance with the program's procedures.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁸ that the proposed rule change (SR-CHX-95-10) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁹

Margaret H. McFarland,

Deputy Secretary.

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[Release 34-36398; File No. 600-23]

Self-Regulatory Organizations; Government Securities Clearing Corporation; Notice of Filing of an Application for Full Clearing Agency Registration and an Application for Extension of Temporary Registration as a Clearing Agency

October 20, 1995.

Notice is hereby given that on February 3, 1995, the Government Securities Clearing Corporation ("GSCC") filed with the Securities and Exchange Commission ("Commission") an application, pursuant to sections 17A and 19(a) of the Securities Exchange Act of 1934 ("Act"),¹ requesting that the Commission grant GSCC full registration as a clearing agency or in the alternative extend GSCC's temporary registration as a clearing agency until such time as the Commission grants GSCC permanent registration.² The Commission is

²⁷ Moreover, stopped orders as "limit orders" would not bypass pre-existing limit orders on the same side of the market. Under CHX's procedures, specialists may not execute a stopped order before the limit order interest on the Exchange (at the same price as the stopped order) is exhausted.

²⁸ 15 U.S.C. 78s(b)(2).

²⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78q-1, 78s(a) (1988).

² Letter from Charles A. Moran, President, GSCC, to Brandon Becker, Director, Division of Market Regulation ("Division"), Commission (February 3,

publishing this notice to solicit comments from interested persons on GSCC's application.

On May 24, 1988, the Commission approved, pursuant to Sections 17A and 19(a) of the Act and Rule 17Ab2-1(c) thereunder,³ the application of GSCC for registration as a clearing agency for a period of three years.⁴ The Commission subsequently has extended GSCC's registration until November 30, 1995.⁵

GSCC provides clearance and settlement services for its members' transactions in government securities. GSCC offers its members services for next-day settling trades, forward settling trades, auction takedown activity, the multilateral netting of trades, the novation of netted trades, and daily marking-to-the-market. In connection with GSCC's clearance and settlement services, GSCC provides a centralized loss allocation procedure and maintains margin to offset netting and settlement risks.

At the time of GSCC's initial temporary registration, the Commission granted GSCC exemptions from compliance with the participation standards in Sections 17A(b)(3)(B) and 17A(b)(4)(B) and with the fair representation requirements in Section 17A(b)(3)(C).⁶ GSCC has requested that the Commission remove GSCC's exemption from the participation standards in Sections 17A(b)(3)(B) and 17A(b)(4)(B). As more fully set forth in the February Registration Letter, GSCC believes that it has adequately addressed the Commission's concerns regarding GSCC's membership eligibility standards by establishing new categories of membership.⁷ In the May

1995 ("February Registration Letter"). GSCC supplemented the February Registration letter in its letter from Charles A. Moran, President, GSCC, to Brandon Becker, Director, Division, Commission (September 15, 1995) ("September Registration Letter").

³ 17 CFR 240.17Ab2-1 (1994).

⁴ Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19639.

⁵ Securities Exchange Act Release Nos. 29067 (April 11, 1991), 56 FR 15652; 32385 (June 3, 1993), 58 FR 32405; and 35787 (May 31, 1995), 60 FR 30324.

⁶ The Commission determined that GSCC's rules did not enumerate the statutory categories of membership as required by Section 17A(b)(3)(B) or the financial standards for applicants and members as contemplated by Section 17A(b)(4)(B). 15 U.S.C. 78q-1(b)(3)(B), 78q-1(b)(4)(B) (1988). In addition, the Commission determined that while the composition of GSCC's Board of Directors reasonably reflected GSCC's anticipated initial membership, it would be appropriate to reevaluate whether GSCC's process for selecting its Board of Directors complied with the fair representation requirements in Section 17A(b)(3)(C) before granting full registration as a clearing agency. 15 U.S.C. 78q-1(b)(3)(C) (1988).

⁷ Since the Commission's original order granting GSCC temporary registration, the Commission has

Continued

²³ 17 CFR 240.11b-1(a)(2)(ii).

²⁴ Section 11(b) permits a specialist to accept only market or limit orders.

²⁵ See H. Rep. No. 1383, 73d Cong. 2d Sess. 22, S. Rep. 792, 73d Cong. 2d Sess. 18 (1934).

²⁶ See Special Study, *supra* note 18.